

B. LESSENING THE BURDENS OF GOVERNMENT

by

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1. Introduction

A "facts and circumstances test." Few words send fear into the hearts of agents, specialists, and tax practitioners as do the words, "facts and circumstances" test. In a world where the cut and dried is revered, cerebral forays into amorphous concepts are looked forward to as much as excursions into the dentist's chair. The determination of whether an organization's activities lessen the burdens of government is based upon a facts and circumstances test. Open wide and say "Ahh!".

In the past, three CPE articles dealt with lessening the burdens of government. The history behind lessening the burdens of government as a charitable activity is discussed in the 1984 CPE text, p. 217.

In 1987, the CPE text, at pp. 139-43, discussed the general application of Rev. Rul. 85-1, 1985-1 C.B. 177, and Rev. Rul. 85-2, 1985-1 C.B. 178.

A CPE article in 1992, dealt tangentially with lessening the burdens of government. The 1992 article on Economic Development Corporations (at page 156) discussed whether Small Business Administration organizations and incubators qualify for section 501(c)(3) exemption on a lessening the burdens of government basis. For cases involving economic development corporations, please refer to that article.

This article will apply existing precedents to a number of situations in an effort to educate the reader on how to analyze, develop and rule on a lessening the burdens of government case. Included along the way will be a discussion of technical advice and general counsel memoranda issued subsequent to the release of Rev. Ruls. 85-1 and 85-2, both cited above. Please remember that private letter rulings and general counsel memoranda are cited for illustrative purposes only, and are not to be used or cited as precedent.

2. The Precedent

The determination of whether an organization's activities lessen the burdens of government involves two tests. First, it is necessary to determine whether the

governmental unit considers the activities to be its burden. Second, the activities must actually lessen such burden of the government. Rev. Rul. 85-2, 1985-1 C.B. 178.

3. Whether the Activity Is a Burden of Government

An activity is a burden of government if there is an objective manifestation by a governmental unit that it considers the activities of the organization to be its burden. Rev. Rul. 85-1, 1985-1 C.B. 177. Whether an objective manifestation exists may be shown by a variety of factors - some of which should be given more weight than others. Perhaps the clearest way to demonstrate an objective manifestation is to have a statute that specifically creates the organization and clearly defines the organization's structure and purposes.

Example 1: An organization is formed pursuant to a state statute. The statute provides that the existence, development, and expansion of industry are essential to the economic growth of the State and to the full employment, welfare and prosperity of its citizens. According to the statute, financing projects through issuance of revenue bonds is in the public interest and serves a public purpose of the State in that it promotes the economic welfare of the State's citizens by securing and retaining private industrial and manufacturing enterprises, resulting in higher employment, economic activity and stability. The statute provides for the creation of industrial development corporations to serve these public purposes. The statute further provides that a development corporation shall have a board of directors appointed by the governing body of the political subdivision, shall have its bylaws approved by the governing body, shall have all programs and expenditures approved by the governing body, and shall have all books and records reviewed by the governing body on an annual basis.

Analysis: Based on the substantial level of direct government involvement in and oversight of a development corporation's activities, the government has objectively manifested that it considers the corporation's activities to be a governmental burden. (See G.C.M. 39852 (June 19, 1991)). In essence, the government is conducting the activities itself, through its instrumentality (the corporation). A government's own activities will generally be considered a "burden" of government.

A statute, however, will not always provide such a clear path toward exemption. Often, a statute which allows development corporations to be created will not define the structure or purposes of the organization as clearly as the statute in the above example.

Example 2: A state statute provides that financing projects through issuance of revenue bonds is in the public interest and serves a public purpose of the State in that it promotes the economic welfare of the State's citizens by securing and retaining private industrial and manufacturing enterprises, resulting in higher employment, economic activity and stability. The statute provides for the creation of industrial development corporations to serve these public purposes. In essence, **Example 2** involves the same statute as in **Example 1**, except this statute lacks any other provisions regarding the structure and/or operation of the development corporation.

Analysis: Where an organization seeks to show that its activities lessen a burden of government on the basis that a state statute authorizes the activities it performs, the statute must be read in its entirety to ascertain whether the legislative body intended such activities to be performed on a normal commercial basis or by a limited class of nonprofit organizations. If the statute, read as a whole, indicates that the legislative body intended that activities be performed by the private sector, albeit with public support, such activities should not be considered to lessen the burdens of government. Therefore, in **Example 2**, the organization has not shown the requisite objective manifestation of a government that this activity is its burden. See G.C.M 38693 (April 15, 1981).

When faced with the situation in **Example 2**, what other factors can the organization point to that would indicate an objective manifestation by a government that a particular activity is its burden? In general, the organization can demonstrate that a governmental unit invited the organization to take part in an activity actually being performed by the government. The organization can show that it acts jointly with a governmental unit or that a governmental unit has allowed the organization to assume the operation of the activity. The organization can show that the activity is an integral part of a larger program of a governmental unit. In sum, the organization must demonstrate that a governmental unit considers the organization to be acting on the government's behalf, thereby freeing up government assets - human, material, and fiscal - that would otherwise have to be devoted to the particular activity.

More specifically, the following factors (among others) may be relevant:

(1) Interrelationship with governmental unit

The interrelationship between a governmental unit and the organization may provide evidence that the governmental unit considers the activity to be its burden. The stronger the control a government has over the activities of the organization, the better the evidence of an objective manifestation. If a government appoints all directors of the organization, that is strong evidence that the government considers the activity to be its burden. If, on the other hand, a government appoints less than half the directors, the fact that a government appoints members to the board is less significant.

Be certain to distinguish between organizations in which there is governmental participation versus those organizations in which participation is by public officials acting outside of their official capacity. While governmental participation in the activities of an organization strongly indicates that a governmental burden exists, the mere presence of a public official on a board of directors in a non-official capacity does not indicate the existence of a governmental burden.

(2) Activity previously conducted by governmental unit

When a governmental unit engages in an activity on a regular basis for a significant length of time before it is taken over by an organization, the activity may be a burden of government. See G.C.M. 39347 (March 15, 1985). That an organization engages in an activity that is sometimes undertaken by a governmental unit is insufficient in and of itself to establish that a burden of government exists. See Rev. Rul. 85-2.

(3) Payment of governmental expenses

That the organization defrays the general or specific expenses of a local government or pays part of the government's debt is evidence of a governmental burden. See G.C.M. 39733, (May 24, 1988), discussed below.

(4) Sources of funding

The funding of an organization's activities may also indicate a governmental burden. If an organization regularly receives funding from the government in the form of general grants, as opposed to fees for services, that may indicate that the

government considers the activity to be its burden. Note that in Rev. Rul. 85-2, the organization was supported in part by grants from a juvenile court, a governmental unit. That an organization's activities are funded with general obligation bonds (those backed with the full faith and credit of the governmental unit) similarly may indicate that a burden of government exists. On the other hand, revenue bond financing should be given little weight, since such financing is commonly made available to private organizations.

(5) Whether activity is one that could be performed directly by governmental unit

In all cases where an organization claims to lessen the burdens of government, one must ascertain whether the activity engaged in by the organization is one that, in fact, could be performed by a governmental unit. State constitutions or statutes may prohibit municipalities from engaging in certain activities. If an organization is created to perform these prohibited activities, it is not entitled to exemption on a "lessening the burdens" basis. After all, if the government cannot perform an activity, how can that activity be a burden of government?

For example, in G.C.M. 38693, cited above, exemption was denied to an organization created under a state statute to operate as an economic development corporation. The organization, which was controlled by a political subdivision, was authorized by the political subdivision to borrow money to provide business facilities to private interests in hopes of increasing employment. The constitution of the state in which the organization was located however, prohibited a political subdivision from lending its credit to a private corporation. The memorandum concluded that the organization did not operate to lessen the burdens of government because the local government was prohibited from making expenditures for the purposes for which the organization would expend money. Since the government itself could not conduct the activity, the organization could not claim to be lessening the burdens of government.

In G.C.M. 39852, cited above, an organization formed under the same statute as the one involved in G.C.M. 38693 was ruled to be exempt on the basis that its activities lessened the burdens of government. Chief Counsel distinguished the two cases by noting that while both organizations' stated purposes included promoting higher levels of employment, economic activity and stability, the organization in G.C.M. 38693 sought to achieve these goals through activities that could not be considered burdens of government because there is reasonable doubt whether the local government would be authorized to expend public funds to aid private corporations in the manner contemplated. In 1989, the act under which both

organizations were created was amended to eliminate the statutory and constitutional prohibitions relied upon in G.C.M. 38693 to deny the development corporation exempt status. The removal of these constitutional barriers allowed exemption to be granted to the organization in G.C.M. 39852.

To assist in determining whether an activity is one the government is permitted to conduct, the specialist should ask the organization to document the propriety of the activity.

Example 3: Public Industries was formed to purchase goods made by prisoners for resale to the general public. The goods will be purchased from Federal Prison Industries, Inc. (Prison Industries), a corporation established by Congress to provide training and employment for inmates at federal correction facilities. The statute creating Prison Industries provides that Prison Industries shall determine the extent to which industrial operations shall be carried on to produce commodities for consumption in such institution or for sale to the departments or agencies of the United States, but not for sale to the general public in competition with private enterprise.

Analysis: Based on the foregoing, Public Industries cannot argue that its sales to the general public constitute a burden of government because Prison Industries itself is prohibited from conducting sales to the general public. See Public Industries, Inc. v. Commissioner, 61 T.C.M. 1626 (1991).

4. Whether the Organization Is Actually "Lessening" the Burdens of Government

Whether the organization is actually lessening the burdens of government is determined by considering all relevant facts and circumstances.

In LTR 9208002 (October 15, 1991), the Service ruled in technical advice that the operation of three motor vehicle registration facilities by an otherwise charitable organization ("M") was an unrelated trade or business because, although the activity was a burden of government, the organization did not actually lessen the burden. In this case, a statute gave the Commissioner of Public Safety of a local government authority to appoint any individual or corporation to serve as a deputy registrar of motor vehicles. M was appointed to three deputy registrar positions. For each vehicle registered, M retained a portion of the fee for its services. It remitted the remainder of the license fee to the state.

In discussing whether the activities actually lessened a burden of government, the Service noted that M's activities did not differ from those of taxable individuals or corporations throughout the state which also served as deputy registrars. The government had merely contracted with M to perform clerical duties associated with its burden of registering vehicles. Thus, the relationship between M and the local government was more in the nature of a commercial contract for services as opposed to a lessening of a governmental burden.

Thus, where the facts show a government satisfies its burden by contracting, on a commercial basis, for goods or services, then the organization providing those goods or services does not "lessen" the government's burden.

Example 4: A non-profit organization was formed to initiate and develop plans and programs to reduce vehicle deaths and injuries by providing free expert opinions to local government officials regarding hazardous traffic conditions in the community and conducting programs to inform the public about traffic safety. The organization is supported by contributions from the general public.

Analysis: The above example is based on the facts in Rev. Rul. 76-418, 1976-2 C.B. 145, which holds that such an organization qualifies for exemption under IRC 501(c)(3). While the revenue ruling predates Rev. Ruls. 85-1 and 85-2, the result under the two-part test established by those rulings would be the same. The first part of the test is whether the activity is a burden of government. In Rev. Rul. 76-418, the Service stated that performing certain services for the benefit of federal, state or local governments has been recognized as a charitable activity and that traffic control and safety are universally recognized as a governmental responsibility. The relationship between the government and the organization in Rev. Rul. 76-418 also indicates the existence of a burden of government in that the organization's services are requested by local governments and delivered to the government free of charge. The income of the organization is derived from contributions from the general public. Based on the above factors, the activity is a burden of government.

The second part of the test, whether the activity actually lessens the burden, is also satisfied. By providing expert opinions to local government officials, the organization relieves the government of an activity it would otherwise have to perform. Therefore, the activities of the organization actually lessen the governmental burden.

Example 5. Same as **Example 4**, except that instead of providing expert opinions to the local government free of charge, the organization charges the government an amount which is equal to or greater than the cost of providing the information.

Analysis: The same governmental burden - traffic control and safety - is present in **Example 5** as in the previous example. But, now that the organization charges fair market value, or above, for its services, do the activities of the organization actually lessen that burden?

The answer is probably no. The government is paying fair market value for the services it receives. Although there is a history of prior governmental involvement in this activity, that fact does not alone establish that the organization is lessening the government's burden. No other facts indicating a "lessening" of the burden are present in the facts of **Example 5**.

Example 6. Same as **Example 5**, except that the local government appoints the board of the organization.

Analysis: Normally, the interrelationship between the government and the organization is a factor in determining whether an activity is a burden of government. It may also shed light on the second part of the test - whether the activity actually lessens the burden. (See Rev. Rul. 85-2, where this factor was considered on the "lessening" element.) Presumably, the local government perceives some benefit to itself in conducting its activities through a separate organization; otherwise, it would not have chosen to structure its activities in this fashion. The government's determination as to the most convenient, efficient, or cost-effective means of conducting its own affairs should generally be respected.

Thus, based on the additional fact in **Example 6** that the organization's board of directors is controlled by the local government, exemption would be justified. For another example where government control played an important role in the determination of exemption, see G.C.M. 39852, discussed above.

Example 7. Same as in **Example 5**, except that the organization charges the local government an amount which is somewhat less than the fair market value of the services. The cost is subsidized by contributions from the general public.

Analysis: An in **Examples 5** and **6**, the activity in question is a "burden" of government. In **Example 7**, however, the organization is charging an amount which is less than fair market value but not "substantially below cost."

"Substantially below cost", however, may be a separate and independent basis for exemption under IRC 501(c)(3). For an example of an organization that qualifies for exemption on a "substantially below cost" rationale, see Rev. Rul. 71-529, 1971-2 C.B. 234, which holds that a nonprofit organization that provides assistance in managing participating colleges' and universities' endowment or investment funds for a charge substantially below cost qualifies for exemption under IRC 501(c)(3). For a contrary result, see Rev. Rul. 72-369, 1972-2 C.B. 245, which holds that an organization formed to provide managerial and consulting services at cost to unrelated exempt organizations does not qualify for exemption under IRC 501(c)(3).

What effect, if any, does the modest discount have on the analysis of whether the organization "lessens" a governmental burden? While the organization is relieving the government of expenses it would otherwise have to pay, it is not clear whether that relief would be considered as "lessening" the burden. If these facts arise, transfer of the case to the National Office would be appropriate.

5. Application of Rev. Ruls. 85-1 and 85-2

The Service has applied the rationale of Rev. Ruls. 85-1 and 85-2 in several recent general counsel memoranda, two of which are discussed below.

G.C.M. 39685

In G.C.M. 39685 (Dec. 10, 1987), the Service considered whether an organization lessened the burdens of government where it created a secondary market in guaranteed student loans and administered, serviced, and collected loans held by other lenders and secondary market entities. The G.C.M. discussed two organizations, A and B, located in different states. A and B both operated in accordance with the Higher Education Act of 1965, 20 U.S.C Sections 1071 et seq. (the "Act"). The Act transferred substantial responsibility for guaranteed student loan programs to state governments or non-profit organizations acting on behalf of states. Organizations acting under this statute are regulated by the Department of Education.

A was created by executive order of a state governor to acquire student loan notes pursuant to a state-wide guaranteed student loan program. A's directors must be

approved by the governor. To further its purposes, A issued private activity revenue bonds under section 103(e) of the Internal Revenue Code of 1954 (now section 146 of the Internal Revenue Code of 1986). By the terms of its articles, A must devote its income, after payment of expenses, debt service, and creation of reserves, to purchasing additional student loan notes. In addition to its loan acquisition activities, A developed a method of administering, servicing, and collecting student loans notes at low cost. A proposed to provide these services to new entrants to the guaranteed student loan market and to members of regional banking systems with respect to student loans held in their portfolios.

B was created to function as a secondary market for guaranteed student loans in a particular state as well as in neighboring states. It planned to seek approval of the state student loan finance corporation to participate in the state's guaranteed student loan program. Instead of revenue bond financing, B proposed to finance its acquisition of student loan notes by issuing taxable debt instruments.

G.C.M. 39685 concluded that A had been created by a state agency, at the request of the state's governor, to perform functions the state considered burdens of government. Thus, A had demonstrated an "objective manifestation" that it was organized and operated to lessen the burdens of government. [The G.C.M. also concluded that A's loan servicing activities did not lessen the burdens of government and the income derived from those activities was unrelated business taxable income. However, subsequent to G.C.M. 39685, LTR 8723052 (March 11, 1987), ruled, based on additional facts, that the loan servicing activities of the organization in G.C.M. 39685 were related to the organization's exempt purpose of lessening the burdens of government and advancing education. Therefore, the loan servicing activities were not an unrelated trade or business.]

The G.C.M. further concluded that B, unlike A, had not evidenced an objective manifestation that its creation of a secondary market lessened the burdens of its state government. In fact, the state where B was located had established, by statute, an entity to provide secondary financing and servicing to commercial lenders and had granted state tax exemption to that entity. Therefore, B's activities could not be considered a burden of state government, and B did not qualify for exemption.

G.C.M. 39685 provides an excellent example of two organizations created under the same federal statute to perform virtually the same activity, with only one qualifying for exemption on a "lessening the burdens" theory. Whereas A made the requisite showing of an objective manifestation by the government that its activities were burdens of government, B failed to make the same showing. The G.C.M. points

out that B could only demonstrate compliance with a federal statute which, when read in its entirety, indicated that Congress had determined that the federal burdens involved in the guaranteed student loan program are best fulfilled through normal commercial enterprises. Therefore, B could not be said to lessen the burdens of the federal government.

G.C.M. 39733

The issue in G.C.M. 39733 (May 24, 1988), was whether an organization formed to assist governmental units financially by refinancing, acquiring, constructing, improving, leasing or selling property lessens the burdens of government. The G.C.M. discussed three organizations created to help local governments perform essential services by issuing certificates of participation. (A certificate of participation is an investment vehicle created through a series of property transactions. Although important distinctions exist, a certificate of participation resembles a revenue bond in that the holder receives payment from the operation of a specific activity funded in part by the holders purchase of the certificate.)

Concerning the first test of Rev. Ruls. 85-1 and 85-2, whether the activity is a burden of government, the G.C.M. stated that many facts indicated an objective manifestation by the governmental units that they considered the activities of the three organizations to be governmental burdens. The underlying projects - purchasing fire trucks, improving schools, and improving a water supply system which continue to be operated by the governmental unit - were the types of projects and activities commonly assumed by local governments. The organizations' purpose was to assist in financing these projects and activities. The budgets of the local governments provided for the payment of certain operating expenses of the organizations. In addition, the governmental units demonstrated a history of conducting the underlying activities and making expenditures for them.

The facts also demonstrated a close interrelationship and attitude of cooperation between the organizations and the governmental units. For example, the city involved with one of the three organizations agreed to reimburse the organization for any out-of-pocket expenses. Another organization was controlled by the boards of education of the two school districts to which it provided financial services. In the third situation, the government conveyed title to its water system site to the organization to enable the organization to finance the improvements. However, the system was to be operated and maintained by the local government.

According to G.C.M. 39733, the second test of Rev. Rul. 85-2 requires that the activities of the organization, rather than its purposes, be examined to determine whether the organization actually lessens the burdens of government. An organization cannot satisfy the second test of Rev. Rul. 85-2 by reference to a purpose that ostensibly constitutes a burden of government. The memorandum noted that the local governments were still responsible for the underlying activities financed by the three organizations; by using the organizations to provide financial services, the governments avoided the fees charged by commercial companies. Thus, the activities of the three organizations actually lessened the burdens of government.

6. Private Benefit

Often neglected in lessening the burdens cases is a consideration of the private interests served by the organization's activities. Irrespective of whether an organization's activities lessen the burdens of government, the organization must still demonstrate that its activities serve a public rather than a private interest within the meaning of Reg. 1.501(c)(3)-1(d)(1). For a discussion on private benefit generally, see 1990 CPE text, at p. 16.

An organization which claims to lessen the burdens of government must demonstrate that any private benefit received by individuals or businesses is both qualitatively and quantitatively incidental to its exempt purposes. To be qualitatively incidental, the private benefit must be a necessary concomitant of activities which benefits the public at large. To be quantitatively incidental, the private benefit must be insubstantial in the context of the overall public benefit. For application of this qualitative/quantitative concept, see G.C.M. 39741 (June 20, 1988).

In considering private benefit to banks whose student loans were purchased by student loan secondary market organizations, G.C.M. 39685 used a balancing test to determine that the indirect benefits received by banks were overridden by the organization's advancement of two distinct and separable charitable purposes. Organization A required banks to reinvest the proceeds of its purchase of their loans in additional student loans. Thus, each purchase of loans, while benefiting the banks, also resulted in additional funds being made available for similar loans. Private benefit to the banks was therefore qualitatively incidental - the additional loans would not have been made but for the organization's secondary market activities. Similarly, private benefit was quantitatively incidental - each loan purchased resulted in a corresponding amount of additional loan funds.

While G.C.M. 39685 addresses private benefit in discussing the exempt purpose of advancement of education, it also applies its private benefit analysis to the "lessening the burdens" purpose:

In A's case, the commercial nature of the secondary market activities and their possible financial benefit to lenders are counter-balanced by the fact that the proceeds of sales must be devoted to additional loans and by the organization's demonstration that it lessens the burdens of state government. Because neither of these countervailing factors is present in B's activities, we cannot conclude that private benefit is merely incidental to its role in advancing education.

By concluding that the fact that sales proceeds were devoted to additional loans outweighed private benefit in the case of Organization A, G.C.M. 39685 indicates the continuing relevance of private benefit considerations in "lessening the burdens" cases.

In some circumstances, it may be difficult to determine whether an organization, which otherwise qualifies for exemption under a lessening the burdens of government rationale, should be denied exemption on private benefit grounds. If the issue arises in a case, transfer to the National Office is appropriate.

7. False Traps

One should be skeptical of letters from government officials that praise an organization's activities. The relevant determination is whether the activity engaged in by the organization is a burden of government, not whether the government approves of the activity or of the people involved. G.C.M. 37401 (Feb. 2, 1978) states that little if any weight should be given to statements of government officials that merely praise or otherwise express approval of an organization and its activities. The frequency with which governmental officials praise citizen's groups and their activities suggests that the government must more formally recognize the organization and its functions, if those functions are to be considered a governmental burden.

Additionally, one should approach cautiously arguments that if the organization did not participate, the government would have to perform the activity itself. While this argument may be valid in some cases (e.g. volunteer fire companies), it does not hold true for all situations. For instance, under this argument, all major defense contractors would be eligible for exemption because they provide

items which the government needs. Where the arrangement is, in essence, a contract for a government to purchase goods or services, on a commercial basis, there is no "lessening" of the burden because the government pays for the services.

8. Conclusion

"Lessening the burdens of government" occupies only five words in the regulations. IRC 509(a)(3) occupies twelve pages of the regulations. Yet, given the choice between a case involving the labyrinth that is Reg. 1.509(a)-4 or the assemblage and weighing of factors in a "lessening the burdens" case, the specialist might prefer the 509(a)(3) case.

As with any facts and circumstances test, cases will arise in which the correct conclusion is unclear. In that situation, the specialist should focus on (1) the statute creating or authorizing the organization, (2) the control exerted by governmental units over the organization's activities, (3) the interrelationship between the governmental unit and the organization, (4) the organization's funding, (5) whether the organization's activities defray general or specific expenses of the governmental unit, (6) whether the governmental unit has previously engaged in the same activity prior to the organization taking over such activity, and (7) whether the activity is one which the governmental unit may, under state or local law, conduct itself. In addition, other facts and circumstances may be relevant and should be considered.

Once the relevant facts are ascertained, the specialist must weigh the facts and determine whether the organization has made the requisite showing of an objective manifestation by a governmental unit that the organization's activities constitute a burden of government and that the activities actually lessen such burden.

Finally, the specialist must determine whether private interests are served by the organization's activities more than incidentally. If public interests outweigh the private interests served and the organization has satisfied the two-part test set out in Rev. Rul. 85-2, exemption on a lessening the burdens of government basis is appropriate.